China Combats Tax Treaty Abuse: Taxing Authorities Focus on Substance Over Form

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The role of income tax treaties is important at a time when international trade and transactions continue to increase. Countries enter into income tax treaties – also known as double taxation agreements or double tax treaties – on bilateral basis to prevent double taxation (i.e., taxes levied by both countries on the same income, profit, capital gain, inheritance or other item). China has entered into such treaties with more than 80 countries and territories.

However, taxpayer-favorable treaty provisions have also led to an increase in tax avoidance transactions. To curb perceived treaty abuse and other tax avoidance practices, China's Enterprise Income Tax Law of 2008 adopted fundamental principles of anti-tax avoidance in the chapter entitled "Special Tax Adjustments." On January 8, 2009, China's State Administration of Taxation announced the Implementation Measures of Special Tax Adjustment (Provisional) ("Circular 2"), which sets out detailed rules related to such anti-tax avoidance principles. For example, under Circular 2, taxation authorities are required to consider a transaction's substance rather than its form in determining whether a tax avoidance motive exists. Additionally, authorities must consider (1) the time of the transaction and its performance period; (2) the way the transaction is carried out; (3) the relationship among the steps of the transaction; (4) the change in the financial positions of related parties under the transaction; and (5) the transaction's tax results.

A recent case handled by China's Xinjiang Uygur Autonomous Regions Taxation Bureau ("Xinjiang Taxation Bureau") illustrates the focus on tax treaty abuse. In this case, the Xinjiang Taxation Bureau disallowed benefits under China's tax treaty with Barbados for a Barbados-based company that engaged in a share transfer transaction. China's State Administration of Taxation supported the decision via Notice No. 1076 of 2008, issued last December. This case can be summarized as follows:

Facts

In 2003, two Chinese companies, B and C, established a joint venture, Company A, in Xinjiang. In July 2006, Company B transferred part of its shares of Company A to a Barbados company for the price of $33.8 million. Shortly thereafter, Company B increased the registered capital of Company A by the amount of the $33.8 million proceeds. In June 2007, the Barbados company sold its shares of Company A back to Company B for approximately $46 million, and claimed an exemption from the otherwise-applicable Chinese tax under the provisions of the tax treaty between China and Barbados.

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Issues

At issue in the case was whether the Barbados company should be considered a bona fide resident of Barbados, thereby entitling it to benefits under the tax treaty.

The Xinjiang Taxation Bureau's investigation indicated that the Barbados company was set up one month prior to the share transaction in 2006. The 2007 sell-back price was contractually arranged in advance, and the Barbados company had no intent to participate in the operation of the joint venture or incur any risk. The transactions were completed within a relatively short period of time (11 months), and resulted in the Barbados company achieving an unusually high return (i.e., a profit of $12 million on an investment of $33.8 million). Viewed together, the transactions arguably more closely resembled a loan or other commercial transaction, rather than an actual investment in the shares of the joint venture company. Moreover, all directors of the Barbados company were U.S. citizens. Based on these facts, the State Administration of Taxation determined that the Barbados

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company should not be considered a Barbadian resident for purposes of applying the tax treaty, despite the fact that it was technically "resident" in Barbados under applicable Barbadian law.

Comments

China will now focus on the purpose or motive for a commercial transaction in order to combat tax treaty abuse. Foreign investors should pay careful attention to commercial arrangements that might be considered a mere attempt to avoid, reduce, or delay tax. In order to prove a valid purpose, foreign investors should be prepared to demonstrate, with appropriate documentation, the economic substance of companies located in jurisdictions with which China has entered into tax treaties. ❑

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